No. 82-1263

Office - Supreme Court, U.S.
FILED
APR 14 1983
ALEXANDER STEVAS,
CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1982

PAUL F. KENDRICK, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

REX E. LEE
Solicitor General

D. LOWELL JENSEN
Assistant Attorney General

Department of Justice
Washington, D.C. 20530
(202) 633-2217

DANIEL L. GOELZER
General Counsel

PAUL GONSON
Solicitor

LINDA D. FIENBERG
Associate General Counsel

WHITNEY ADAMS
Assistant General Counsel

LARRY R. LAVOIE
Senior Special Counsel

JEFFREY B. MALETTA
Attorney

Securities and Exchange Commission
Washington, D.C. 20549

QUESTION PRESENTED

Whether the scheme of a securities broker to pledge (without a customer's knowledge or consent) an interest in that customer's securities and to misappropriate the proceeds of that pledge, is prohibited by Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5(c), 17 C.F.R. 240.10b-5(c).

TABLE OF CONTENTS

	Page
Opinion below	1
Jurisdiction	1
Statement	1
Argument	5
Conclusion	9

TABLE OF AUTHORITIES

Cases:

Chiarella v. *United States*, 445 U.S. 222 6

Henricksen v. *Henricksen*, 640 F.2d 880, cert. denied, 454 U.S. 1092 6

Marine Bank v. *Weaver*, 455 U.S. 551 7

McMann v. *SEC*, 87 F.2d 377, cert. denied, 301 U.S. 684 6

O'Brien v. *Continental Illinois National Bank & Trust Co.*, 593 F.2d 54 ..... 6, 7

Panter v. *Marshall Field & Co.*, 646 F.2d 271, cert. denied, 454 U.S. 1092 6

Rolf v. *Blyth, Eastman, Dillon & Co.*, 570 F.2d 38, cert. denied, 439 U.S. 1039 6

Rubin v. *United States*, 449 U.S. 424 7

Santa Fe Industries, Inc. v. *Green*, 430 U.S. 462 6

SEC v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180 8

Page

Cases—Continued:

Superintendent of Insurance v. *Bankers Life & Casualty Co.*, 404 U.S. 6 7

Touche Ross & Co. v. *Redington*, 442 U.S. 560 2

United States v. *Bohonus*, 628 F.2d 1167, cert. denied, 447 U.S. 928 6

United States v. *Bush*, 522 F.2d 641, cert. denied, 424 U.S. 977 6

United States v. *Lovasco*, 431 U.S. 783 5

United States v. *Naftalin*, 441 U.S. 768 8

Statutes and rules:

Securities Exchange Act of 1934, Title I, 15 U.S.C. (& Supp. V) 78a *et seq.* :

Section 3(14), 15 U.S.C. 78c(14) 5, 7
Section 10(b), 15 U.S.C. 78j(b) 1, 5, 7
Section 15(c)(3), 15 U.S.C. 78*o*(c)(3) 2

18 U.S.C. 1621 1

17 C.F.R. 240.10b-5(c) 1, 5

17 C.F.R. 240.15c3-1 2

Miscellaneous:

3 L. Loss, *Securities Regulation* (1961) .....

In the Supreme Court of the United States

OCTOBER TERM, 1982

No. 82-1263

PAUL F. KENDRICK, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINION BELOW

The opinion of the court of appeals (Pet. App. A-1 to A-20) is reported at 692 F.2d 1262.

JURISDICTION

The judgment of the court of appeals was entered on November 22, 1982. A petition for rehearing was denied on December 20, 1982. The petition for a writ of certiorari was filed on January 28, 1983. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

Following a jury trial in the United States District Court for the Northern District of California, petitioner was convicted on two counts of securities fraud in violation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5(c), 17 C.F.R. 240.10b-5(c), and one count of perjury in violation of 18 U.S.C. 1621.[1]

[1]The jury could not reach a verdict on a third securities count charging an additional violation of Section 10(b) and Rule 10b-5(c).

Petitioner received concurrent five-year sentences on each of the three counts, with all but six months suspended, and a $10,000 fine for each of the securities fraud counts (Pet. App. A-22 to A-23). The court of appeals affirmed (Pet. App. A-1 to A-20).

1. The evidence at trial showed as follows. In 1976, petitioner was president of Kendrick & Co., a securities brokerage firm located in San Francisco, California. On August 20, 1976, the National Association of Securities Dealers ("NASD") warned petitioner that Kendrick & Co. was operating in violation of the "net capital rule." [2] That rule is the principal regulatory tool with which the Securities and Exchange Commission protects customers against the risks of financial insolvency of brokerage firms holding their cash or securities (Tr. 3-12).

In order to conceal his firm's net capital deficiency, on August 23, 1976, petitioner deposited a personal check for $150,000 in the bank account of Kendrick & Co. He then informed the NASD that the firm's net capital problem had been solved (Tr. 10-13, 55-57). At the time, petitioner had less than $5,000 in his personal bank account (Tr. 858). The same day, petitioner removed $150,000 from a margin account[3] that Kendrick & Co. maintained for one of its

---

[2]Section 15(c)(3) of the Securities Exchange Act of 1934, 15 U.S.C. 78*o*(c)(3), and Rule 15c3-1, 17 C.F.R. 240.15c3-1, require that brokers maintain a minimum amount of liquid assets, known as "net capital," to ensure payment of their customers' claims for cash or securities. See *Touche Ross & Co.* v. *Redington*, 442 U.S. 560, 570 & n.10 (1979).

[3]A margin account permits a customer to purchase securities on credit extended by his broker. When a customer purchases securities on margin, the customer must initially provide at least 50% of the purchase price of the securities. The broker takes a security interest in the securities purchased in an amount sufficient to secure the loan, and usually retains possession of the securities (Tr. 178-179). The broker may thereafter lend additional monies to his margin account customer, accepting as collateral a pledge of a greater security interest in stock already in the customer's margin account (Tr. 180-181).

customers, Lawrence Spitters, at another brokerage firm, Dean Witter (Tr. 134-140, 155-156). Spitters was away on vacation at the time, and never approved the transaction (Tr. 134-137, 142).[4] Dean Witter recorded the transaction as a $150,000 loan to Spitters, entrusted petitioner with a check for $150,000 payable to Spitters, and took as collateral for the loan a security interest in common stock which Spitters maintained in the margin account (Tr. 142, 155-156, 186). Dean Witter's $150,000 check was deposited in Kendrick & Co.'s bank account, with Spitters' endorsement forged on it (Tr. 142-143). The $150,000 was then transferred to Kendrick's personal bank account to cover the original check to Kendrick & Co. (which had been used to cure the firm's net capital problem) (Tr. 71-72). Later, petitioner contacted Spitters and falsely represented that he had used the $150,000 to purchase government securities for Spitters (Tr. 136-137, 182-183).[5] This transaction was the basis for petitioner's conviction on the first securities fraud count.

---

[4]Spitters' account at Dean Witter was nondiscretionary; Kendrick & Co. employees were required to get Spitters' approval prior to effecting any transactions in the account (Tr. 134, 188). A Dean Witter representative testified that the firm permits brokers to exercise discretion over margin accounts maintained with it *only* upon filing with Dean Witter an express written authorization by the brokers' customers (Tr. 187). Dean Witter had no written authorization from Spitters permitting Kendrick & Co. to exercise discretion over his margin account (Tr. 188). Petitioner requested the district court to instruct the jury that he had "implied authority" to effect transactions in Spitters' account without Spitters' prior approval. The district court refused, however, to give such an instruction, and the court of appeals affirmed that ruling (Pet. App. A-11 to A-12).

[5]Spitters ordered the unauthorized transactions in his account to be reversed, notwithstanding petitioner's representation that a profit could be made by simply ratifying the purported purchase of government securities (Tr. 136, 149).

In order to obtain funds to transfer $150,000 back to Spitters' Dean Witter account, petitioner secretly removed over $100,000 from a bank account which he maintained for another customer, the Congregation

In September 1976, petitioner bought securities for his own account at Kendrick & Co., but had insufficient funds to cover the personal checks he wrote to pay for the purchases (Tr. 98-105). Petitioner, therefore, removed $27,000 from a margin account maintained at Dean Witter for a second client, the Congregation of the Passion, a Roman Catholic religious order (Tr. 202-203, 404). As in the case of the Spitters' transaction, Dean Witter recorded a $27,000 loan to the Congregation, entrusted petitioner with a $27,000 check payable to the Congregation, and took as collateral for the loan a security interest in common stock held in the margin account (Tr. 201-203). The Congregation's endorsement on the check was forged, the check was deposited in Kendrick & Co.'s bank account, and the $27,000 was ultimately transferred to petitioner's personal bank account to cover the checks he had written (Tr. 222-223). Representatives of the Congregation had no knowledge of the transaction (Tr. 404, 406-407).[6] In order to conceal his misappropriation, petitioner subsequently represented to the Congregation that the $27,000 had been borrowed from its margin account to purchase securities for the Congregation's own account (*ibid.*). This transaction was the basis for petitioner's conviction on a second securities fraud count.

---

of the Passion, a religious order. During an investigation by the Commission in 1978, petitioner falsely testified that he had asked for permission to borrow this money from the Congregation (Tr. 498-499). Petitioner's false testimony was the basis of his conviction for perjury in this case (see page 1, *supra*).

[6]Unlike Spitters' margin account, the Congregation's account was discretionary. Petitioner's own expert witness conceded, however, that petitioner had no authority to engage in transactions in the account to secure money *for his own use* (Tr. 579-580).

2. The court of appeals (Pet. App. A-1 to A-20) found that there was "no merit whatsoever" to petitioner's contention that his conduct was not a fraudulent practice prohibited by Section 10(b) of the Securities Exchange Act of 1934 and by SEC Rule 10b-5(c) (Pet. App. A-10). The court noted that petitioner not only failed to disclose to his customers that he was using their accounts for his own purposes, but also falsely represented to each customer that he had used the money properly to acquire securities for them (*id.* at A-10). The court also rejected the contention that there was no "sale" of a security within the meaning of the statute and regulation (*id.* at A-6 to A-9). The court found that a "sale," within the meaning of Section 3(14) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(14), occurred when Dean Witter acquired an additional interest in the customers' securities as collateral for $177,000 in loans (Pet. App. A-9); Dean Witter was the "purchaser" of an interest in the securities, and Spitters and the Congregation were the "sellers" whom petitioner defrauded (*id.* at A-8). Finally, the court rejected petitioner's contention that his fraudulent conduct was not "in connection with" the purchase or sale of securities (*id.* at A-10 to A-11). As the court explained, petitioner "was engaged in fraud" when he pledged an interest in his customers' securities (*id.* at A-11).

ARGUMENT

1. Petitioner argues (Pet. 17-31) that his activities were not fraudulent because he had no duty to disclose them to his customers.[7] Petitioner's argument is, however, based on a mischaracterization of the evidence against him. Petitioner's convictions do not rest on mere silence. Petitioner was

---

[7]The court of appeals found that this argument, which was presented for the first time in petitioner's reply brief in the court of appeals, had not been properly raised before it (Pet. App. A-10 n.3). Accordingly, this argument has not been preserved for this Court's review. See *United States* v. *Lovasco*, 431 U.S. 783, 788 n.7 (1977).

convicted for engaging in schemes involving a number of acts of concealment, including affirmative misrepresentations to his customers.[8] The schemes were calculated to conceal from his customers, the NASD, Dean Witter and others, the fraudulent pledges of his customers' stock. Active concealment of the truth is itself fraudulent, even absent an independent duty to speak. See *United States* v. *Bohonus*, 628 F.2d 1167, 1172 (9th Cir.), cert. denied, 447 U.S. 928 (1980); *United States* v. *Bush*, 522 F.2d 641, 651 (7th Cir. 1975), cert. denied, 424 U.S. 977 (1976); 3 L. Loss, *Securities Regulation* 1434-1435 (1961).[9]

---

[8]Petitioner's argument (Pet. 15, 27, 29) that the court of appeals' decision in this case conflicts with *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462 (1977), and *Panter* v. *Marshall Field & Co.*, 646 F.2d 271 (7th Cir.), cert. denied, 454 U.S. 1092 (1981), is without foundation. In *Santa Fe* the defendant had "furnished * * * all relevant information" to the plaintiffs, and therefore had not engaged in any form of deception. 430 U.S. at 474-475. Similarly in *Panter* the defendants had disclosed all material facts, and consequently there was not "sufficient evidence to support a * * * finding of the element of deception required by Section 10(b) and Rule 10b-5." 646 F.2d at 293. By contrast, as the court of appeals found (Pet. App. A-10), the evidence in this case amply demonstrated that petitioner did not make full disclosure of all material facts.

[9]Even assuming that petitioner's conduct could be described as mere nondisclosure, it would be fraudulent on the facts of this case. As a broker, petitioner was the agent and fiduciary of his customers. See, *e.g.*, *Henricksen* v. *Henricksen*, 640 F.2d 880, 886 (7th Cir.), cert. denied, 454 U.S. 1092 (1981); *Rolf* v. *Blyth, Eastman, Dillon & Co.*, 570 F.2d 38, 45 (2d Cir.), cert. denied, 439 U.S. 1039 (1978); *McMann* v. *SEC*, 87 F.2d 377, 378 (2d Cir.), cert. denied, 301 U.S. 684 (1937). His silence therefore operated as a fraud on the customers. Indeed, it is the existence of this fiduciary duty that readily distinguishes this case from *Chiarella* v. *United States*, 445 U.S. 222, 232 (1980), relied upon by petitioner (Pet. 19-21).

Contrary to petitioner's contention (Pet. 22-26), there is no inconsistency between the decision below and that of the Seventh Circuit in *O'Brien* v. *Continental Illinois National Bank & Trust Co.*, 593 F.2d 54 (1979), with regard to fraud in a fiduciary relationship. In *O'Brien*, the court stressed that the defendant, a bank trustee, had "sole discretion" to make the securities transactions in dispute. 593 F.2d at 57. Accordingly, the court held that the plaintiffs could not recover damages under

2. Petitioner next argues (Pet. 32-38) that there was no "sale" of securities involved in his scheme to save his brokerage firm. Petitioner does not, however, discuss the statutory definition of "sale" or cite any decision indicating that the pledge of a security to obtain a loan is not a sale of a security. As the court of appeals held (Pet. App. A-6), petitioner caused securities to be "sold" within the meaning of Section 3(14) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(14), when he pledged stock to obtain loans from Dean Witter. As this Court recently observed, "a pledge of stock is equivalent to a sale for the purposes of the antifraud provisions of the federal securities laws." *Marine Bank* v. *Weaver*, 455 U.S. 551, 554 n.2 (1982). See also *Rubin* v. *United States*, 449 U.S. 424 (1981). It was no defense that the securities were already subject to a security interest owned by Dean Witter. As the court of appeals found (Pet. App. A-9), Dean Witter gained an "additional" $177,000 interest in the securities when it advanced that sum of money using the securities as collateral.

Nor is there any merit to petitioner's related contention that even assuming a sale, his fraud was not "in connection with" the sale. This Court has interpreted the "in connection with" language of Section 10(b) broadly to reach "deceptive practices *touching* [the] sale of securities * * *." *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 12-13 (1971) (emphasis added). The required nexus is clearly satisfied where, as here, a sale is essential to the

---

Section 10(b) for the alleged breach of a fiduciary duty based on non-disclosure. 593 F.2d at 63. By contrast, here petitioner had no discretion over Spitters' margin account at Dean Witter, and clearly exceeded any discretion that he had over the Congregation's account (see note 4 and 6, *supra*). Moreover, unlike the trustee in *O'Brien*, petitioner engaged in affirmative concealment of his securities transactions.

success of a scheme to defraud. The court of appeals correctly held that it is sufficient that petitioner was "engaged in fraud" when he pledged his customer's securities (Pet. App. A-11). In any event, petitioner's argument (Pet. 39-42), that some "causal connection" between his deceptive conduct and the sale of a security is required, was plainly satisfed in this case. But for petitioner's active concealment of the nature of his actions, neither Dean Witter nor the customers would have permitted petitioner to pledge the securities that were involved in this case.

3. Finally, there is no merit to petitioner's suggestion (Pet. 13-16) that his fraudulent activity is a matter of concern only to the states, and that the decision below will lead to a flood of cases in federal court that should be decided by state courts. Regulation of the fiduciary relationship between securities brokers and their customers cannot be described as a concern solely of state law. Such regulation is essential to the federal effort " 'to achieve a high standard of business ethics * * * *in every facet of the securities industry.*' " *United States* v. *Naftalin*, 441 U.S. 768, 775 (1979), quoting *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186-187 (1963) (emphasis in original).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

REX E. LEE
Solicitor General

D. LOWELL JENSEN
Assistant Attorney General

DANIEL L. GOELZER
General Counsel

PAUL GONSON
Solicitor

LINDA D. FIENBERG
Associate General Counsel

WHITNEY ADAMS
Assistant General Counsel

LARRY R. LAVOIE
Senior Special Counsel

JEFFREY B. MALETTA
Attorney
Securities and Exchange Commission

APRIL 1983

DOJ-1983-04